COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF:	)	
	)	
NOTICE OF ADJUSTMENT OF THE RATES OF	)	CASE NO. 2004-00103
KENTUCKY AMERICAN WATER COMPANY	)	
EFFECTIVE ON AND AFTER MAY 30, 2004	)	

DIRECT TESTIMONY OF MICHAEL M. MILLER

April 30, 2004

KENTUCKY AMERICAN WATER COMPANY
CASE NO. 2004-00103
DIRECT TESTIMONY
<u>MICHAEL A. MILLER</u>

1. Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Michael A. Miller, 1600 Pennsylvania Avenue, Charleston, West Virginia.

2. Q. WHAT POSITION DO YOU HOLD WITH KENTUCKY AMERICAN WATER?

A. I am the Vice President and Treasurer/Comptroller of Kentucky American Water Company ("KAW" or "Company").

3. Q. PLEASE DESCRIBE YOUR PROFESSIONAL EDUCATION AND EXPERIENCE.

A. My resume is attached to this testimony in Appendix A.

4. Q. WHAT ARE YOUR RESPONSIBILITIES AS VICE PRESIDENT, TREASURER AND COMPTROLLER?

A. I am responsible for the customer service (billing, credit, and customer contact), rates and revenue, business development, accounting, finance, budgets, and cash management functions for the five Southeast Region Operating Companies, including KAW.

5. Q. HAVE YOU TESTIFIED BEFORE IN REGULATORY PROCEEDINGS?

A. Yes. I have testified previously before the utility regulatory agencies in West Virginia, Tennessee, Maryland, Virginia and the Kentucky Public Service Commission in case number 2000–120 on behalf of Kentucky American Water.

6. Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. I will address (i) capital structure and the overall cost of capital that includes the return on equity (ROE), which will be addressed by Mr. Vander Weide, (ii) certain elements of management fees, (iii) requested rate recovery of deferred and on-going security costs, (iv) rate treatment for other deferrals, (v) the current reorganization plans for American Water, (vi) rate base for rate recovery, (vii) Performance Based Ratemaking, as required in the Commission order in case 2000-120, (viii) changes in monthly accounting closing schedules, (ix) allocation of costs, and (x) tariffs other than metered tariffs proposed in this case.

<u>GENERAL</u>

7. Q. WHAT FACTORS ARE DRIVING THE NEED TO INCREASE RATES AT THIS TIME?

A. The Company's ability to attract capital at reasonable rates is a critical factor in meeting its public service obligation. The Company must replace and construct facilities necessary to meet water quality regulations and

maintain its service capabilities (an increase in rate base of $17.078 million is being requested over the level on which rates are currently based), maintain its facilities in order to maximize their useful life, and provide the employees necessary to carry out those public service obligations. Rates should be set to provide revenue to the utility to cover all prudently incurred operating and capital costs, including the opportunity to achieve a fair and reasonable return on the investment by the stockholders. It is essential that the Company's rates be set at levels to cover its <u>cost of service</u> if it is to continue to maintain service levels, meet its public service obligations and attract capital at reasonable rates. The Company has not increased rates in nearly four years from those approved in case number 2000-120, and as a condition to the change of control proceeding for the purchase of American Water was precluded from filing for increased rates before March 16, 2004. As can be seen on Exhibit MAM-1 attached to this testimony, the Company's achieved ROE has been significantly under the level authorized by the Commission for 2002 and 2003. Without rate relief, the achieved ROE for 2005, the forecasted test-year in this case, is expected to dip to 7.14%. The Company does not believe that a 7.14% ROE is sufficient and the only reasonable alternative is to seek an increase in rates.

<u>CAPITAL STRUCTURE & OVERALL COST OF CAPITAL</u>

8. Q. WHAT CAPITAL STRUCTURE DID THE COMPANY USE IN CALCULATING THE COST OF SERVICE (REVENUE REQUIREMENT)

IN THIS CASE?

A. The Company used the capital structure for the thirteen month average of the forecasted test-year ending November 30, 2005. The capital structure proposed by the Company is attached to this testimony as Exhibit MAM-2 and is also included in the filing documents on schedules J-1 thru J-4 and additional information is included in workpapers filed with the case. Exhibit MAM-2 indicates the thirteen month average capital structure on which the Company based its cost of service and revenue requirement in this case. The proposed capital structure is comprised of 3.719% Short-term debt, 51.376% Long-term Debt (55.095% Total Debt), 3.780% preferred stock, and 41.125% Common Equity.

9. Q. IS THE CAPITAL STRUCTURE PROPOSED BY THE COMPANY IN LINE WITH THE CAPITAL STRUCTURES HISTORICALLY APPROVED BY THE COMMISSION FOR SETTING THE COMPANY'S RATES?

A. Yes. The Company has historically maintained its debt capital in the 53-57% range and its common equity ratio between 40-45%. The Company believes this mix of debt and equity in the capital structure is in line with rating agency expectations for an "A" rated water utility, and in line with capital structures previously approved by the Commission. The Company believes a capital structure of 55-58% debt and 40-45% common equity provides a capital structure that enables the Company to attract capital at reasonable

costs and balances both the stockholder requirements and the rates paid by the customers as determined in the ratemaking process.

10. Q. IN WHAT MANNER DOES THE COMPANY CURRENTLY OBTAIN ITS LONG-TERM AND SHORT-TERM DEBT?

A. The Company utilizes the services of American Water Capital Corp. ("AWCC") to place its long-term (LT) and short-term (ST) debt requirements. AWCC is an American Water Company affiliate and was created to consolidate the financing activities of the operating subsidiaries, to effect economies of scale on debt issuance and legal costs, to attract lower debt interest rates through larger debt issues in the public market, and to use more cost effective means of obtaining ST debt (to bridge the gap between permanent debt financings) than the historical bank lines of credit previously used. The Company believes the use of AWCC has permitted the Company to attract capital at lower interest rates and resulted in lower issuance and transaction costs by utilizing the combined size and resources of the entire American Water System. That is evidenced through the overall cost of capital that is included in this case.

11. Q. HAS THE COMMISSION APPROVED THE COMPANY OBTAINING ITS DEBT THROUGH AWCC?

A. Yes. By Order entered July 21, 2000 in Case No. 2000-189, this Commission authorized the Company to enter into a Financial Services Agreement with

AWCC to periodically issue debt securities in the form of notes or debentures for the purpose of placing debt issues to replace ST debt or refinance maturities of existing debt not to exceed the aggregate amount of $41.5 million. With the financing just completed on March 1, 2004 the Company has issued $38 million of permanent debt since inception of the agreement with AWCC.

12. Q. HAS THE COMPANY BEEN PLEASED WITH THE RESULTS THUS FAR?

A. Yes. The Company and its customers have benefited from the interest savings resulting from pooling the capital requirements of the American Water subsidiaries. On March 31, 2004 the Company filed with the Commission a "Statement of Best Practices" initiated since the change of control as required by the Commission order in that case. Described in the filing and table 1.3 are the benefits derived from the affiliations with AWCC and RWE\Thames for the two LT Debt issues placed since 2002. I am attaching table 1.3 included in the March 31, 2004 filing as Exhibit MAM- 3 to this testimony. The interest savings and issuance costs are shown for the $24.0 million issued on June 6, 2002 and the $14.0 million issued on March 1, 2004 and aggregate to annual savings of $121,900 which are embedded into the weighted cost of capital proposed by the Company in the current rate filing. In addition, the Company's $5.5 million, 6.79% issue will mature in October 2005 and the Company has included additional savings for the

refinancing of that issue in the 13-month average weighted cost of LT Debt used in this filing. In addition, the pooling and bidding of the ST debt requirements for all American Water subsidiaries through AWCC has lowered the cost for ST debt.

13. Q. WHAT FACTORS REQUIRE THE COMPANY TO SEEK ADDITIONAL CAPITAL?

A. The Company has documented in past rate cases and in this filing that capital improvements to meet the new and changing regulations in the water industry, replace aged treatment and distribution facilities, and provide quality, reliable water service to its customers have driven and will continue to drive the need for new capital. In addition, the Company will be required to replace maturing debt series over the coming years including the $5.5 million, 6.79% series that matures in September 2005, and the $24.0 million, 5.65% series that comes due in June 2007. It is important that the Company maintain a strong financial position in order to continue to attract this capital at the lowest possible price and to provide service improvements at the least possible cost to its customers.

14. Q. WHY IS THE LEVEL OF SHORT-TERM DEBT INCLUDED IN THE COMPANY'S FILING APPROPRIATE FOR SETTING RATES IN THIS CASE?

A. The Company uses a significant amount of its ST debt to finance capital

improvements. This type of financing is used to bridge the gap between permanent financings. This permits the Company to time permanent financings in a cost-effective manner and to take advantage of the optimum permanent debt market conditions as they occur. The Company believes the capital structure used to set rates should reflect the capital components that will be in place to finance the rate base on which rates will be set in this case. The Company has based the level of ST debt used in its proposed capital structure in this case on the thirteen month average capital structure for the forecasted test-year ending November 2005. That level of ST debt is reflective of the level that will be utilized to fund construction and other cash peaking requirements during the forecasted test-year.

15. Q. YOU MENTIONED EARLIER THAT THE COMPANY INCLUDED A PERMANENT DEBT FINANCING SCHEDULED FOR SEPTEMBER 2005. PLEASE DESCRIBE THAT PROPOSED FINANCING AND THE INTEREST RATE EXPECTED?

A. The Company's $5.5 million, 6.79% LT Debt issue matures on September 1, 2005. The Company has included in the calculation of the 13-month average capital structure and weighted cost of debt to replace this issue with a $5.5 million, 30-year issue with a forecasted interest rate of 6.6%.

16. Q. PLEASE EXPLAIN WHY YOU USED A 30-YEAR TERM AND HOW DID YOU ARRIVE AT THE INTEREST RATE OF 6.6%?

A. The Company has been monitoring the market spreads for 10-year and 30-year maturities to the Treasury Bonds on which permanent debt rates are bid. The spreads on 30-year "A" rated Utility Bonds compared to 30-year Treasury Bonds have been declining over the last year. The current Value Line forecast for 2005 indicates that this trend will continue, and we expect the market conditions based on this forecast to be favorable to the longer 30-year maturities. Attached to this testimony as Exhibit MAM-4 is a schedule that provides a range of interest rate calculations based on the most recent two and four quarter spreads between "A" rate Utility bonds and 30-year Treasury Bonds, and applies those spreads to the most recent Value Line Forecast for 30-year Treasury Bonds in 2005, the forecasted test-year in this case. Based on this information, I believe the estimate of an interest rate on that issue of 6.6% is reasonable based on the most recent data available.

17. Q. HOW WAS THE COST RATE FOR SHORT-TERM DEBT DETERMINED?

A. The Company reviewed market forecasts to determine a cost rate for ST debt that will likely be in place during the forecasted rate year. The most recent Value Line forecast indicates an average "fed funds" rate of 2.3% for 2005. The Company is proposing a ST interest rate calculated using a 40 basis point premium over the current Value Line forecast for the "fed funds" rate in 2005.

18. Q. HOW WERE THE WEIGHTED COSTS OF LONG-TERM DEBT AND PREFERRED STOCK DETERMINED?

A. The face value of each issue was reduced by the unamortized issuance cost and the result was divided by the total capital to arrive at the percentage each series had to total capital. This result was then multiplied by the cost rate to arrive at the weighted cost for each series. The weighted cost for each series of LT Debt and Preferred Stock were totaled to arrive at the overall weighted cost of LT Debt and Preferred Stock.

19. Q. HAS THE COMMISSION PREVIOUSLY ADDRESSED THE METHOD IN WHICH THE WEIGHTED COST OF LONG-TERM DEBT AND PREFERRED STOCK ARE DETERMINED?

A. Yes. The method used to determine the weighted cost of LT Debt and Preferred Stock was an issue in the Company's last rate case, case number 2000-120. The Commission Order indicates the methodology described in the previous answer and used historically by the Commission for setting rates of the Company was appropriate and was approved.

20. Q. WHAT IS THE OVERALL COST OF CAPITAL REQUESTED IN THIS CASE AND HOW DOES IT COMPARE TO THAT CURRENTLY APPROVED IN RATES?

A. The overall weighted cost of capital being requested is 8.25%, compared to the overall cost of capital of 9.09% approved in case 2000-120, and on which

current rates are based. This reduction in the overall cost of capital equals 84 basis points, or a reduction of over 9%. This reduction in the weighted cost of debt equates to a savings in the revenue requirement requested in this case of approximately $640,000 compared to the level currently embedded in rates and reflects favorable LT Debt financings since the previous case and savings generated due to the use of AWCC as previously described in this testimony. The Company is requesting the ROE be increased to 11.2%, which the Company believes is the cost of equity as supported by Mr. Vander Weide; however, due to a reduction in the ratio of equity capital, the weighted cost of equity is 11 basis points lower than approved in Case 2000-120.

21. Q. HAVE YOU REVIEWED THE TESTIMONY OF COMPANY WITNESS VANDER WEIDE IN THIS CASE REGARDING COST OF EQUITY?

A. Yes. Mr. Vander Weide recommends a range of returns based on various accepted methods of determining the cost of equity using DCF and Risk Premium calculations. The Company has filed the case using an 11.2% ROE recommended by Mr. Vander Weide.

<u>MANAGEMENT FEES</u>

22. Q. DESCRIBE THE MANAGEMENT FEE COST INCLUDED IN THE COMPANY'S FILING?

A. The Company has included its forecasted test-year management fees,

including the annualization of the cost of the National Customer Care Center. The Company made the transition to the Center in October 2003.

23. Q. THE COMMISSION IN ITS ORDER IN THE PRIOR COMPANY RATE CASE ADDRESSED SEVERAL AREAS REGARDING MANAGEMENT FEES. DID THE COMPANY ADDRESS THOSE COMMENTS IN THIS FILING?

A. Yes. In the previous rate case (2000-120) the Company provided testimony about the transition to the Southeast Region Office of American Water Works Service Co. and the forecasted net cost of that transition was approved as part of the rates awarded in that case. In this case the Company will examine the current forecasted cost of the SE Region along with those of the transition to the National Customer Care and Shared Services (transactional accounting) Centers. The Company has continued to explore and implement "best practice" efforts in providing customer accounting, billing, general accounting, finance, and rates functions at lower costs when those savings could be demonstrated and service could be improved. The following testimony will address those three transitions and the overall cost benefits of providing the improved high quality services on a consolidated basis.

24. Q. PLEASE DESCRIBE THE OVERALL BENEFITS OF THE TRANSITION OF VARIOUS FUNCTIONS TO THE SOUTHEAST REGION, AND THE

NATIONAL CUSTOMER CARE AND SHARED SERVICE CENTERS?

A. Attached to this testimony is Exhibit MAM-5 that provides the forecasted test-year costs for these three Service Company offices allocated to KAW and offsetting expenses previously incurred directly by KAW. Exhibit MAM-5, page 1 of 5 provides a summary of the cost benefits of those transitions. The Company in its forecasted test-year has identified total expense savings of $232,268. The offsetting cost elements are described more fully in Exhibit MAM-5, pages 2 thru 5. The Company is also requesting a 10-year amortization of the unamortized balance in the deferred transition costs to the National Customer Care and Shared Services Centers. The Company has embedded in the current rate filing savings, net of the transition cost amortization, of $119,377.

25. Q. WHAT STEPS HAS THE COMPANY TAKEN REGARDING THE DEFERRAL OF THE SHARED SERVICES AND CUSTOMER CALL CENTER TRANSITION COSTS?

A. The Company filed a letter with the Commission dated September 6, 2001 requesting to defer a number of items as required in the Order in Case No. 2000-120, including the transition cost to the Shared Services and Customer Care Centers. The Company did not receive a response to that letter. On December 12, 2003 the Company filed a petition requesting the Commission grant deferral of the items originally included in the letter of September 6, 2001 and the security expense. Later sections of this testimony will address

the security issue. The petition of December 12, 2003 and the letter of September 6, 2001 are attached as Exhibit MAM - 6.

26. Q. WHAT IS THE COMPANY'S POSITION ON THE DEFERRAL OF THE SHARED SERVICES AND CUSTOMER CARE CENTER TRANSITION COSTS?

A. The Company has consistently indicated that it was not seeking guarantees of future rate recovery for these costs in its request for deferral, but the ratemaking treatment would be determined in a future rate case. Because there were specific cost savings related to these transitions the Company believes it is appropriate under FAS 71 to defer the transition costs and amortize those transition costs at the level of expected savings until they are addressed in a rate proceeding. The Company began the amortization of the transition cost once the Shared Services and Customer Care Centers were providing the services. Now that the Company is filing a general rate case the Company believes the ratemaking issues can be addressed as always contemplated by the Company.

27. Q. THE COMPANY'S CUSTOMER SERVICE AND BILLING FUNCTIONS WERE MOVED TO ALTON, ILLINOIS AS PART OF AWW'S CONSOLIDATED CUSTOMER CARE CENTER IN OCTOBER 2003. PLEASE DESCRIBE THIS MOVE AND ITS PURPOSE.

A. The Company and the other American Water System operating companies

are striving to provide customer service that will be more responsive, provide increased customer service options, improve customer satisfaction, and effect cost savings wherever possible. Beginning in October 2003, the customer inquiry and billing functions for the Company are being performed at the Customer Care Center in Alton, Illinois. The first companies to move to this shared services format were New Jersey-American and Long Island Water Company in April, 2001, West Virginia American in May, 2001, Pennsylvania-American in July, 2001, and Missouri-American in November, 2001, and Illinois-American in June 2002. Since then the operating subsidiaries in Maryland, Virginia, Tennessee, California, Arizona, New Mexico, Indiana, Iowa, and Ohio now receive customer service and billing services from the Customer Care Center.

The American System has as one of its primary goals to provide customer service unsurpassed in the water industry. At the same time, we hope to provide that service at the lowest reasonable cost. The Customer Care Center will help us meet both of these important goals.

28. Q. HOW DID THE COMPANY AND THE OTHER AMERICAN SUBSIDIARIES OPERATE THE CUSTOMER SERVICE AND BILLING FUNCTIONS BEFORE TRANSITIONING TO THE NATIONAL CENTER?

A. The Company and the other subsidiaries operated independent call centers

and billing functions in their respective service territories.

29. Q. WHY WAS THIS A PROBLEM AND HOW WILL THE CONSOLIDATION IMPROVE SERVICE?

A. Although the Company has always provided acceptable customer service, there were limitations on that service because of the size of the Company. The local customer service function was operated five days a week from 8:00 a.m. to 4:30 p.m. The Company provided only emergency coverage after normal working hours and on weekends. In today's business environment, customers demand more in the way of service availability and increased functionality. The American Water System had historically maintained a common customer service and billing software platform; however, programming had been handled either locally or regionally. This led to numerous versions of the common software platform, and had become a problem when multi-state acquisitions or software upgrades were required. In essence, multiple conversions were required to facilitate the various software versions. This cost time and money for the subsidiaries. In short, it limited our ability to take full advantage of the economies of scale available to the American Water System.

The Customer Care Center is operated using the ORCOM customer service and billing software. The software program is uniform for all subsidiaries, and this will make future software migrations and acquisition integration

projects easier to accomplish and less costly.

In addition to the software improvements, the Customer Care Center provides full customer service on a twenty-four hour, seven day a week basis. There are also enhancements for automated call answering, automated payment options, communications with field operations, and bill editing processes through significant improvements in the various technologies employed. The individual operating companies could not provide this enhanced service on a cost-effective basis. The Customer Care Center will increase the availability of full service to the customers on an around-the-clock basis, and provide the additional services that our customers demand in today's environment.

30. Q. DOES THIS MEAN THAT THE COMPANY WILL HAVE NO LOCAL PRESENCE FOR CUSTOMER SERVICE?

A. No. The Company will still have its Corporate Office in Lexington. There remains a clerical staff to coordinate billing and collections for the entities for which we perform those functions. We will still provide customer contact as required, resolve customer issues relayed from Alton, and respond to Commission inquiries. In addition, the field personnel will continue to be available to address the needs of our customers. The local payment locations will remain unchanged. This transition should be transparent to the customers.

31. Q. WOULD YOU PLEASE DESCRIBE THE OFFSETTING SAVINGS OF THE MOVE TO THE NATIONAL CUSTOMER CARE CENTER?

A. Yes. As indicated earlier attached to this testimony is Exhibit MAM-5, Page 2 of 5 that provides the labor and benefit savings generated by the move to the Center. The schedule indicates a reduction in labor and labor related expenses of $533,690 through elimination of 9 positions. In addition, MAM-5, page 3 of 5 recaps the other customer accounting expense savings generated since the previous rate case of $264,245 including elimination of temporary positions, and reduction in various miscellaneous expenses.

32. Q. YOU ALSO INCLUDE TRANSITION COSTS FOR THE MOVE TO THE CUSTOMER CARE CENTER. PLEASE DESCRIBE WHAT MAKES UP THESE COSTS AND THE RATE TREATMENT THE COMPANY IS REQUESTING IN THIS CASE.

A. As with any project of this type, there are costs required to make the transition possible and to make it go smoothly. The Company deferred its allocated portion of these one-time costs until the actual move to the Center took place in October 2003. It then began to amortize these costs based on the estimated savings generated. The Company is requesting the unamortized balance at the beginning of the forecasted test-year December 1, 2004 be amortized over a ten-year period. Those costs are made up of severance costs, moving costs for those associates electing to relocate to Alton, consulting costs to set up the processes and training, and in-house

costs charged for setup and training.

The Company requests that the Commission recognize the $571,405 as a necessary cost of making the transition and afford regulatory asset status for those costs. The Company requests also that those costs be amortized over a ten-year period starting with the effective date of the rates approved in this case, with the unamortized amount included as rate base.

33. Q. THE COMPANY MOVED ITS TRANSACTIONAL ACCOUNTING FUNCTIONS TO THE NATIONAL SHARED SERVICES CENTER LOCATED IN MARLTON, NEW JERSEY EFFECTIVE JANUARY, 2002. PLEASE DESCRIBE THIS MOVE AND ITS PURPOSE?

A. In 1999 and 2000 AWW undertook a review of its accounting functions to determine how it could improve its transactional accounting functions, take advantage of economies of scale where possible, and improve the uniformity of its software applications at the various operating subsidiaries. The Company had previously installed JD Edwards accounting software, but like the customer accounting and billing software, local and regional programming had in essence created several different versions of the software. This created difficulties with consolidated accounting and multi-jurisdictional acquisition integrations. AWW determined there were economies of scale savings and operational efficiencies to be derived from providing transactional accounting functions on a national level and decided

to move these functions to a Shared Services Center. Prior to this transition, the accounting, budgets, and finance functions were being performed by Kentucky American Water employees and the Regional Service Company located in Charleston, WV.

34. Q. HOW DO THESE AREAS CURRENTLY FUNCTION?

A. Transactional accounting (general accounting, payroll, AP, inventory, purchasing, AR, etc.), and actual historical information for budgets and rate cases are provided by the Shared Services Center utilizing a uniform JD Edwards software platform. Review and approval of the financial statements, rate case adjustments, budgets\forecasting, and Board Meeting information and presentations are the responsibility of the Vice-President and Treasurer/Comptroller and a minimal staff located at the Southeast Regional Service Company office, and two employees at Kentucky American Water

35. Q. WOULD YOU PLEASE DESCRIBE THE OFFSETTING SAVINGS OF THE MOVE TO THE NATIONAL SHARED SERVICES CENTER?

A. Yes. Attached to this testimony is Exhibit MAM-5, pages 4 and 5 that indicate the savings generated by transition of certain accounting, rates and finance functions to the to the Shared Service Center and the Southeast Region Office.

36. Q. WOULD YOU PLEASE DESCRIBE THE INFORMATION CONTAINED IN EXHIBIT MAM - 5, PAGES 4 AND 5?

A. Page 4 of 5 indicates a reduction in expenses of $1,039,794 comprised of the labor and labor related expenses associated with 12 positions that were either transferred to vacant positions in other areas of the Company or to the Southeast Region Office, or in some cases left the Company. Page 5 of 5 provides documentation of general accounting expense reductions by account type totaling $29,285 that have been reduced at the Company since the 2000 rate case. The total identifiable savings in the areas of finance, rates, general accounting, and business development total $1,069,079.

37. Q. YOU ALSO INCLUDE TRANSITION COSTS FOR THE MOVE TO THE SHARED SERVICES CENTER. PLEASE DESCRIBE WHAT MAKES UP THESE COSTS AND THE RATE TREATMENT THE COMPANY IS REQUESTING?

A. As with any project of this type, there are costs required to make the transition possible and to make it go smoothly. The Company deferred its allocated portion of these one-time costs until the actual move to the Center took place in January 2002. It then began to amortize these costs based on the estimated savings generated. The Company is requesting the unamortized balance at the beginning of the forecasted test-year December 1, 2004 be amortized over a ten year period. Those costs are made up of severance costs, moving costs for those associates electing to relocate to the

Center, consulting costs to set up the processes and training, and in-house costs charged for setup and training.

The Company requests that the Commission recognize the $557,506 as a necessary cost of making the transition and afford regulatory asset status for those costs. The Company requests also that those costs be amortized over a ten-year period starting with the effective date of the rates approved in this case, with the unamortized amount included as rate base.

38. Q. WHY SHOULD THE COMMISSION APPROVE THE RATEMAKING TREATMENT REQUESTED FOR THE TRANSITIONS TO THE SOUTHEAST REGION, AND THE NATIONAL CUSTOMER CARE AND SHARED SERVICE CENTERS?

A. The transitions to the Southeast Region, and National Customer Care and Shared Service Centers provides increased functionality and economies of scale for the customer service, billing, accounting, rates and finance functions of the Company. The Company has significantly increased the availability of service to its customers through the expanded hours and services made possible by the transition to the Customer Care Center. Moving the accounting software to a uniform platform will permit the Company to streamline future software migrations, streamline acquisition integrations, and will facilitate improved rate case and budget preparation. The Company will receive these benefits at a significantly reduced cost to the ratepayers.

The Company has a public service obligation to provide its customers the best possible service at the lowest possible cost. The information contained in this testimony and in Exhibit MAM-5 clearly indicates the Company has met that service obligation, therefore, the rate treatment requested is prudent, appropriate and supported by lower costs. The Company respectfully requests that the Commission recognize its efforts in these areas and recognize for ratemaking purposes the deferred transition costs required to make these initiatives possible as regulatory assets for setting rates in this case. The Company also proposes to amortize those transition costs over an appropriate period in order to match a portion of the savings that will now flow to the customers in the form of lower operating costs embedded in this case.

39. Q. IN YOUR POSITION OF V.P. FINANCE FOR THE SOUTHEAST REGION ARE YOU AWARE OF HOW OTHER REGULATORY JURISDICTIONS HAVE TREATED THE TRANSITION COSTS TO THE NATIONAL CUSTOMER CARE AND SHARED SERVICE CENTERS?

A. Yes. I have been the witness who requested similar rate recovery for the American Water subsidiaries in West Virginia, Virginia and Tennessee. In each of those instances the Commissions have approved rate recovery of the transition costs as justified by similar cost savings and service improvements as those demonstrated by KAW in this case. I have also reviewed rate filings and Orders of all other American Water regulated subsidiaries and know of

no other jurisdiction that has denied similar prudently incurred and cost justified expenditures for rate recovery.

SECURITY COSTS

40. Q. MR. MILLER, WOULD YOU DISCUSS THE RATE RECOVERY OF DEFERRED AND ON-GOING COSTS EXPENDED FOR INCREASED SECURITY SINCE THE EVENTS OF SEPTEMBER 11, 2001?

A. Yes. The Company is requesting recovery of it deferred additional security costs estimated to be $2.805 million at November 30, 2004 (the beginning of the forecasted test-year in this case), and recovery of $143,194 for on-going security costs, its estimated 2005 on-going cost for security. The total expense portion of the requested recovery (amortization and ongoing) is approximately $424,000 per year, a significant driver of the increased revenue requested in this case.

41. Q. WILL YOUR TESTIMONY ADDRESS THE TYPE OF EXPENSES DEFERRED AND ON-GOING, OR THE NEED FOR THOSE EXPENSES?

A. No. That testimony will be provided by Mr. Bruce Larson and Mr. Ken Rubin, who have extensive experience and expertise in the area of security. I will address the cost incurred, the rate recovery requested and the synergies generated as indicated in the "Best Practices" filing of March 31, 2004.

42. Q. WOULD YOU GIVE A BRIEF SUMMARY OF THE HISTORY OF THE

FILINGS MADE BY THE COMPANY BEFORE THE COMMISSION REGARDING ITS EFFORTS AND COSTS TO PROVIDE ADDITIONAL SECURITY FOR THE CUSTOMERS AND EMPLOYEES?

A. Yes. As we all know the events of September 11, 2001 changed the way many of us in America viewed the threat of terrorist attacks. While the Company has always maintained a level of security at its facilities, those security measures were primarily addressing vandalism and accident avoidance. In light of the events of September 11, 2001, it became prudent and necessary for KAW to implement measures to prevent raw and finished water contamination, infrastructure attacks and computerized tampering. Shortly after September 11, 2001 the Company realized that the costs of the additional security measures required would be substantial and believed the best way to address these additional costs was to seek a specific "surcharge" to recover these increased costs from the rate payers that were receiving the benefit of the additional protection. On November 28, 2001, the Company made a filing before the Commission (Case No. 2001-440) seeking to establish such a surcharge to be adjusted quarterly to the actual level of expense incurred. The Commission in its Order (Condition 2) approving the change of control of American Water required the withdrawal of the Asset Protection Charge tariff, and indicated that the recovery of costs associated with protection of water utility assets to occur only in cases for the adjustment of general rates for water service. On June 10, 2002 KAW filed its notice withdrawing its asset protection tariff. On July 8, 2002 case 2001-

440 was removed from the Commission's docket.

43. Q. HOW DID THE COMPANY ACCOUNT FOR ITS INCREASED SECURITY EXPENSE AFTER THE WITHDRAWAL OF CASE NUMBER 2001-440?

A. The Company continued to defer its additional security costs believing that the language in the Order in Case Number 2002-00018 permitted that accounting deferral, to be fully reviewed for possible rate recovery in its next general rate filing. After several discussions and conferences with the Commission Staff, a letter was filed with the Commission on September 24, 2003 by Lindsey Ingram Jr., attorney for the Company, on behalf of KAW to Mr. Thomas Dorman seeking specific accounting deferral of its additional security costs and costs to defend itself in the condemnation effort of the Lexington-Fayette Urban County Government (LFUCG). Both the letter from Mr. Ingram of September 24, 2003 and Mr. Dorman's response on behalf of the Commission of October 15, 2003 are attached to this testimony as Exhibit MAM-7, pages 1-4. Mr. Dorman's letter of October 15, 2004 indicates the Commission Staff concluded it was not appropriate to grant the Company's request. The letter from Mr. Dorman indicates that the establishment of a regulatory asset for security costs is prohibited by Condition 2 of the Order in case number 2002-00018.

44. Q. WHAT DID THE COMPANY DO AFTER RECEIVING THE LETTER

FROM MR. DORMAN ON OCTOBER 15, 2003?

A. The Company decided not to pursue its request regarding deferring expenses to defend itself against condemnation by LFUCG. The Company did not agree with the Staff position on deferred security expenses. The Company does not believe Condition 2 in the Order of case 2002-00018 precludes deferral of security expenses, but does specifically preclude rate recovery of those expenses unless addressed in a general rate filing. On November 18, 2003 Mr. Lindsey Ingram Jr. responded to Mr. Dorman, and that letter is attached to this testimony as Exhibit MAM-8. This letter requested that the Commission Staff reconsider its position regarding security expense as indicated in its letter dated October 15, 2003.

45. Q. WHAT DOES CONDITION 2 OF THE ORDER IN CASE NUMBER 2002-00018 SAY?

A. The condition is: "At no time prior to May 30, 2007, will KAW apply to the Commission for recovery of costs associated with the protection of water utility assets except through adjustments in its general rates for water service."

46. Q. WHAT DOES THIS CONDITION MEAN TO THE COMPANY?

A. This condition clearly indicates that the Company can only pursue recovery of costs associated with the protection of water utility assets through a general rate filing. The Company is doing that in its 2004 general rate filing.

This condition does not indicate rate recovery is not possible, just not through a surcharge or some other mechanism outside a general rate filing. The purpose of the Commission's Condition 2 was to freeze the rates of KAW until March 16, 2004, or one year after the closing.

47. Q. ON WHAT BASIS WAS THE COMPANY ASKING THE COMMISSION TO RECONSIDER ITS POSITION IN THE LETTER SENT ON NOVEMBER 18, 2004?

A. In case 2000-120 the Commission ordered the Company to seek approval for any expense it wished to defer for accounting purposes. The request of KAW to defer its security expenses on September 24, 2004 did not seek specific or guaranteed rate recovery for its additional security costs, it was only seeking approval of accounting deferral. Rate recovery would be considered when the Company did file a general rate increase. There seemed to be some confusion about what the Company was requesting or what was meant by approving a deferral. The requested approval for the establishment of a deferral of its security costs would not affect current rates at all and was not precluded by Condition 2. The Company also wanted to clarify that it was not seeking any rate treatment at this time or any guarantee of future rate recovery, only the deferral and ability to pursue the merits of rate recovery in a future general rate case. The Company also included in its letter for reconsideration on November 18 citations to several other jurisdictions where regulatory commissions have dealt with similar requests. In each case

cited in the letter, the Commission in each jurisdiction gave approval to defer the security expense for accounting purposes subject to full review about the appropriateness and prudence of those expenses for rate recovery to be determined in a future general rate proceeding.

48. Q. DID THE COMPANY RECEIVE A RESPONSE TO ITS REQUEST FOR RECONSIDERATION?

A. Yes. On November 21, 2003, Mr. Dorman sent a letter to the Company indicating the Commission Staff was giving additional consideration to KAW's request for approval to defer post September 11, 2001 security costs. The letter also ask the Company to provide copies of Orders of the Missouri PSC Case No. WO-2002-273, Pennsylvania PUC Case No. R-00027983, West Virginia PSC Case No. 03-0353-W-42T, and copies of the petitions of KAW's sister company filings in each of those cases, along with any intervener or third party comments in each case. The letter of November 21, 2003 is attached as Exhibit MAM-9

49. Q. WHAT RATE TREATMENT IS THE COMPANY SEEKING IN THIS CASE REGARDING ITS DEFERRED POST SEPTEMBER 11, 2001 ADDITIONAL SECURITY EXPENSES?

A. The Company is requesting that the deferred balance at November 30, 2004 be amortized over a ten-year period beginning with the effective date of rates approved in this case, with the amortized portion being afforded rate base

treatment. The deferred amount is forecasted to be $2,805,661.79 at that time and the annual amortization would equal $280,566.

50. Q. WHAT IS THE LEVEL OF ON-GOING SECURITY EXPENSES BEING REQUESTED?

A. The Company is requesting its on-going security expenses be approved at $143,194, the level expected in the forecasted test-year.

51. Q. THE ON-GOING SECURITY COST REQUESTED IN THIS CASE APPEARS TO BE SUBSTANTIALLY LOWER THAN THAT INCURRED IN 2002 AND 2003. PLEASE ADDRESS THE LOWER COST?

A. Mr. Larson and Mr. Rubin will address the specifics and justification for both the amounts expended and deferred through November 30, 2004 and for the forecasted test-year. The Company shortly after the events of September 11, 2001 hired security guards to protect its facilities where appropriate for the protection of the customers and employees during the heightened state of alert. The Company believed this to be the best option available. During the change of control proceeding, the Company indicated that Thames Water had much more experience than American Water in issues regarding security and would use that expertise to assure American Water subsidiaries were providing the best security possible at the best possible cost. Thames Water has continued to review the security issues and methods employed at American Water subsidiaries in order to improve the

security and at the same time provide that enhanced security at a lower cost. The Company has made significant capital investments in security that have permitted the Company to lower its reliance on costly security guards. This has culminated in significant reductions in the on-going security costs from those experienced in earlier years.

52. Q. PLEASE PROVIDE THE LEVEL OF O & M EXPENSE SAVINGS REQUESTED IN THIS CASE FROM THE LEVEL EXPENDED IN 2003?

A. The Company expended $951,886 for security in 2003 and is requesting $143,194 for on-going security in this case. This equates to a savings of $808,692 from the 2003 level. The Company, as Mr. Larson and Mr. Rubin will testify, believes that the level of security provided at the lower on-going cost coupled with the capital improvements will provide improved protection to the customers and employees at a substantially lower cost.

53. Q. WHY SHOULD THE COMMISSION APPROVE THE COMPANY'S REQUEST FOR RATE RECOVERY OF BOTH ITS ON-GOING AND DEFERRED ADDITIONAL SECURITY EXPENSE?

A. The events of September 11, 2001, and other terrorist acts across the globe have had an immense impact on the citizens of the United States, and the Company. Additional security measures are a part of providing reliable utility service today in a way that was not envisioned by many prior to September 11, 2001. The Company acted responsibly and prudently in

taking measures to protect its customers and employees. Utility infrastructure and particularly water infrastructure, because water is ingested by humans, was and continues to be listed as a possible target of those who wish to harm our country and its citizens. The Company believes the measures it took shortly after the events of September 11, 2001 were required and has continued to seek ways of providing enhanced security at lower costs. This was done for the protection of the customers and was in line with the public service obligation that the Company is required to meet. The Company respectfully requests that the Commission recognize the extraordinary effort the Company has put forth in protecting its customers and employees, and permit this reasonable and necessary expense to be included in the rate recovery approved in this case.

OTHER DEFERRALS

54. Q. DOES THE COMPANY HAVE OTHER DEFERRED EXPENSES IN THIS CASE THAT IT IS SEEKING RATE RECOVERY FOR?

A. Yes. The Company lists its deferred costs and amortization requests on workpapers that accompany Schedule D of the filing documents. The Company has only five deferrals and amortizations included in this case where rate treatment was not previously addressed in Case No. 2000-120. Three of those deferrals have been addressed previously in this testimony: 1) transition cost to shared services, 2) transition cost to customer care center, and 3) security costs. The Company does have additional deferred costs for

maintenance and waste disposal included in its rate request, with amortization of those items being requested in line with the historical rate treatment afforded those items in past Company rate cases.

55. Q. PLEASE ADDRESS THE FOURTH NEW DEFERRAL?

A. The fourth issue is the acquisition adjustment related to the purchase of the Tri-Village/Elk Lake water systems. The Company believes that the acquisition of the Tri-Village/Elk Lake systems meets the test for rate recovery of acquisition premiums established in the Delta Natural Gas case and is consistent with the ratemaking treatment afforded in the Company's 2000-120 rate case regarding the acquisition of the Boonesboro water system. Mr. Bush and Ms. Bridwell will address the service issues and capital improvements undertaken as part of this acquisition. The Company has continued to pursue the acquisition of small troubled water and wastewater systems at the urging of the Kentucky Division of Water, the Kentucky Public Service Commission, and the Kentucky Infrastructure Authority. The Tri-Village/Elk Lake acquisition was an integral part of the Company's efforts to address water quality and service issues in Owen County, which have continued with the proposed acquisition of the City of Owenton water and wastewater system.

56. Q. WHAT IS THE LEVEL OF ACQUISITION ADJUSTMENT BEING REQUESTED FOR RATE RECOVERY AND OVER WHAT PERIOD IS

THE COMPANY SEEKING A RETURN OF THAT AMOUNT?

A. The acquisition adjustment was for $334,665.60. Upon completion of the acquisition the Company began amortization of the acquisition adjustment over a 40 year period. Under U.S. GAAP, acquisition adjustments are to be written off over a period not to exceed 40 years unless addressed in the ratemaking process. Even though the Company was permitted to amortize the acquisition adjustment in the Boonesboro acquisition over 10 years, the Company is only requesting that the Tri-Village acquisition adjustment be amortized over the 40 year period and the unamortized portion recognized as rate base.

57. Q. WOULD YOU PLEASE ADDRESS THE FIFTH AND FINAL NEW DEFERRED COST ISSUE INCLUDED IN THIS CASE?

A. Yes. The Company has estimated the cost to prepare and prosecute this case will be $622,409 as outlined in the workpapers accompanying Schedule D. Those costs include service company fees, legal fees and consulting fees to address a number of issues. This case has more issues requiring outside consultants than past rate cases and those include: 1) Rate of Return on Equity, 2) Service Company charges, 3) Security measures and costs, 4) lead lag study, and 5) normalization of revenues. The Company is requesting that its cost to prepare and prosecute this case be amortized over a three year period.

AMERICAN WATER REORGANIZATION

58. Q. YOU MENTIONED EARLIER THAT YOU WOULD DISCUSS THE REORGANIZATION THAT IS UNDERWAY AT AMERICAN WATER. PLEASE DESCRIBE THE STATUS OF THAT REORGANIZATION EFFORT?

A. American Water is in the early stages of restructuring its organization. After the purchase of American Water, Bill Alexander (CEO of Thames Water) assumed the position of CEO at American Water upon the retirement of Jim Barr. Mr. Alexander remains Chairman of the Board of American Water and CEO of Thames Water. Jeremy Pelczer has been appointed President and Deputy CEO of American Water. The appointment of Mr. Pelczer has been confirmed by the American Water Board of Directors.

59. Q. WHAT OTHER CHANGES HAVE OCCURRED TO DATE IN THE REORGANIZATION?

A. The American Water System operates in 27 states, 4 Canadian providences, and Puerto Rico. They also are the contract operator for operations in Chile and Brazil in South America. The new American Water has the responsibility for all former American Water properties, as well as the entities operated previously by Thames Water in both North and South America. The merger of these business units into the new American Water required a careful review of the alignment of the operating units and it was decided that in order to manage the new American Water effectively a

realignment of the business units was necessary.

60. Q. WHAT ARE THE NEW REGIONAL ALIGNMENTS?

A. Prior to January 1, 2004, the regulated utilities of American Water operated under seven regional offices located in Chula Vista, CA; St. Louis, MO; Granite City, IL; Indianapolis, IN; Hershey, PA; Haddon Heights, NJ: and Charleston, WV. The new structure will consolidate the seven regions into four regional offices located in Chula Vista, CA; St. Louis, MO; Hershey, PA; and Haddon Heights, NJ.

61. Q. WHAT REGIONAL OFFICE WILL BE RESPONSIBLE FOR THE OPERATIONS OF KENTUCKY AMERICAN WATER?

A. As the Commission is aware there have been several realignments of the Regions of American Water prior to the change of control completed on January 10, 2003. Previous realignments of the regions at American Water were driven by changing business conditions and that is no different in the present realignment. In fact, in the Company's previous rate cases we explained that KAW had been realigned to the Southeast Region Office located in Charleston, WV, after reporting for several years to the Regional Office in Marlton, NJ, and then operating for a short period under no regional service company office. From 1984 to 1994 KAW was aligned with and KAW operations were administered from the Southern Division Office located in Charleston, WV. Effective January 1, 2004, Kentucky American

Water and the operating companies in Pennsylvania, West Virginia, Tennessee and Maryland will come under the direction of the American Water Regional Office located in Hershey, PA.

62. Q. HOW WILL THIS IMPACT KENTUCKY AMERICAN WATER?

A. Although the reorganization is in its early stages, we do not see any significant impact on the Company. The main purpose of the realignment is to more effectively manage the business and to foster increased efficiencies and uniform best practices across the various operating units. While the reorganization will likely create some synergies, it is too early in the process to define the impact on KAW. There will be transition costs associated with the reorganization. To the extent of those savings, the Company intends to amortize those transition costs until they are addressed in a rate filing. At this time, there are no changes regarding the local management of the Company. KAW will simply be reporting to a different Regional Office of the Service Company.

63. Q. WHAT IMPACT WILL THE REALIGNMENT HAVE ON THE SERVICE PROVIDED BY THE COMPANY?

A. The Company has undertaken many transitions in the past, and most recently moved to a national shared services organization for customer service and certain transactional accounting functions. Those initiatives were undertaken to operate as efficiently and cost effectively as possible,

while at the same time providing enhanced service to our customers. This realignment is no different, and we believe the realignment will improve standardization of processes, increase efficiencies, and improve the service provided to the customers of the Company.

RATE BASE

64. Q. MR. MILER, HOW DID THE COMPANY DEVELOP ITS FORECASTED LEVEL OF RATE BASE OF $158.959 MILLION AS SHOWN ON SCHEDULE B-1, PAGE 2 OF 2?

A. The Company developed its rate base by using a 13-month average for most of the items shown on Schedule B-1, page 2 of 2. Some of the elements were calculated using a 24-month average based on the Commission's final order in Case No. 97-034. Many of the rate base elements shown on this schedule, i.e., utility plant in service, accumulated depreciation, customer advances, etc. were analyzed from actual per books data as of January, 2004. Using data and projections for each of the rate base elements, the Company developed a 13-month average for the forecasted test period ending November 30, 2005.

65. Q. PLEASE DESCRIBE HOW THE 13-MONTH AVERAGE FOR THE UTILITY PLANT IN SERVICE (UPIS) WAS CALCULATED?

A. The starting point for the calculation of the 13-month average for utility plant in service was the actual level as of January 2004. From that point through the end of the test period, the Company has forecasted capital expenditures by

month for investment projects 80 through 97 (normal recurring plant investment) and for special Investment Projects (IP) that are non-recurring in nature. These capital expenditures have been approved by the Company's Board of Directors. The forecasted expenditures for all projects were slotted by month based upon the expected cash flow of each project. When the project is complete, all expenditures related to that project will be placed into service. Therefore, the 13-month average of forecasted utility plant in service only reflects the inclusion of projects when they are complete and in service.

The Company also projects utility plant retirements by month. These retirements were deducted from the balance of utility plant in service in the month in which the retirement is expected to occur. Ms. Bridwell will be discussing in further detail in her testimony the Company's planned capital investment program for 2004 and 2005. The total 13-month average forecasted level of Utility Plant in Service is $287.862 million.

66. Q. PLEASE DISCUSS THE REMAINING RATE BASE ELEMENTS ON SCHEDULE B-1, PAGE 2 OF 2.

A. <u>Rate Base - Utility Plant Acquisition Adjustment (UPAA)</u>

The next rate base element as shown on Schedule B-1, page 2 of 2 is utility plant acquisition adjustments. The actual balance in the account as of January, 2004 was $419,160. The UPAA relates to the Acquisition of the Boonesboro Water Association, the Tri-Village system, and the Elk Lake

system. The Company is using a 10-year amortization based on prior Commission treatment of UPAA for Boonesboro, and proposes a 40-year amortization for the Tri-Village and Elk Lake UPAA. The level included in the 13-month average rate base calculation (net of amortizations) for the UPAA in rate base is $391,650.

<u>Rate Base - Accumulated Depreciation</u>

The next rate base element as shown on Schedule B-1, page 2 of 2 is accumulated depreciation. The accumulated depreciation was developed in the same manner as the utility plant in service. The actual balance as of January, 2004 was used as a starting point. This balance was adjusted for forecasted depreciation expense by month, and forecasted retirements by month. The depreciation rates used to develop this item of rate base were approved by the Commission in the Company's depreciation study performed in case No. 95-554, with the exception of two new depreciation rates approved in the Company's last case, Case No. 2000-120. The accumulated reserve for depreciation was developed by month by account from November 2004 through November 2005, with a 13-month average balance of $68.959 million being deducted from rate base.

Rate Base - Accumulated Amortization

The next rate base element as shown on Schedule B-1, page 2 of 2 is for the Company's franchise expense. The actual balance is $7,674 and is being deducted from rate base.

Rate Base - Construction Work in Progress (CWIP)

The next rate base element as shown on Schedule B-1, page 2 of 2 is Construction Work in Progress. The Company is proposing to include in its 13-month average rate base a level of CWIP for the forecasted test period. The 13-month average is $6.125 million. This amount is based on the actual balance as of January 2004, adding forecasted expenditures by month and then deducting amounts transferred to Utility Plant in Service. The forecasted expenditures for all projects were taken from the approved capital expenditures plan and were slotted by month based on expected cash flow. When a project (work order) is complete and in service, the dollars are transferred from CWIP to UPIS.

67. Q. MR. MILLER, THE RATE BASE ELEMENT AS SHOWN ON SCHEDULE B-5, PAGE 2 OF 2 IS THE WORKING CAPITAL ALLOWANCE. WHAT IS WORKING CAPITAL AND WHAT METHOD DID THE COMPANY USE IN CALCULATING ITS WORKING CAPITAL ALLOWANCE IN THE CASE?

A. Working capital is a rate base element that recognizes the amount of investor supplied funds that are used to fund the day to day operation of the Company and to recognize the delay in the recovery of certain expenses from the ratepayers. The Company is using a lead/lag study that was prepared and is being sponsored by Mr. Jim Salser in his direct testimony in this case.

68. Q. BASED ON THE RESULTS OF MR. SALSER'S LEAD/LAG STUDY, WHAT IS THE LEVEL OF WORKING CAPITAL ALLOWANCE BEING REQUESTED BY THE COMPANY IN THIS CASE?

A. The Company is proposing a working capital allowance of $2.957 million.

69. Q. PLEASE CONTINUE WITH YOUR DISCUSSION OF RATE BASE

A. <u>Rate Base - Contributions in Aid of Construction</u>

The next rate base element as shown on Schedule B-1, page 2 of 2 is Contributions In Aid of Construction (CIAC). Again, this element was developed by starting with the actual balance as of January, 2004. The Company has forecasted an increase in these contributions based upon either:

1) **Direct contributions from developers, businesses or government agencies.**
2) **Increases in CIAC as a result of transfers from Customer Advances after 10-year agreements expire.**

The 13-month average balance was developed by analyzing the forecasted activity in the CIAC accounts beginning with November, 2004 through November, 2005 resulting in a forecasted 13-month average balance of $34.548 million.

The Company's forecasted CIAC balance includes the impact of the Company's proposed revision to the tap fee tariff. The revised tap fee tariff is found under Exhibit 2 of the Company's filing.

The revised tap fee tariff indicates the Company will collect from developers or other parties in the Central Division $510 for residential service, $945 for 1" service, $4,250 for 2" service and the actual cost of installing a service and meter for services over 2" in size. For the Tri-Village area, the proposed tap fees would be $530 for residential, and identical to Central Division for 1" and larger services. There is no change to the Elk Lake tap fees. The calculation of the residential, 1" and 2" service amounts are based on a 3-year average of actual costs to install these services and the cost of a meter.

The Company forecasts collection of CIAC from the revised tap fee tariff of $1.577 million, an increase over 2003 levels, and the increased amount would become effective when the results of this case are final and the revision is approved by the Commission. Ms. Bridwell will discuss the calculation of the proposed revision to the tap fee tariff in her direct testimony.

The Tap Fee amounts collected that do not serve multiple customers are taxed as ordinary income to the Company, per IRS regulations. For this reason, the Company has recognized in this filing that all Tapping Fees collected for the 1” and 2” services will serve single customer entities and thus are taxable to the Company. This impact has been incorporated in the Company’s deferred tax liability in rate base and as tax expense.

<u>Rate Base - Customer Advances</u>

The next rate base element is customer advances. The 13-month balance for customer advances was developed in the same manner as were CIAC’s. The Company forecasted receipts and refunds of customer advances and transfer of customer advances to the contributions account by month through the end of the forecasted test period, thus resulting in a 13-month average balance of $15.220 million for the forecasted test period. These forecasted receipts are based on management discussions with local developers and refunds are based on a review of historical trends in this category.

<u>Rate Base - Deferred Income Taxes</u>

Deferred Income Taxes are included in rate base as a reduction to the forecasted 13-month average rate base. The forecasted amount in rate base is $26.562 million. The forecasted amount is shown on Schedule B-1, page 2 of 2 and further detailed on B-6, page 2 of 2 and in the workpapers. There are Deferred Taxes associated with UPIS, Deferred Maintenance, and Deferred

Debits. All of these items have been recognized by the Commission in prior cases with the exception of the deferred taxes applicable to the costs deferred for the shared services center, customer care center, and additional security. Each of these items have been addressed earlier in my testimony.

In this rate case the Company has incorporated SFAS 109 – Accounting for Income Taxes. Both the rate base reduction for income taxes and the calculation of forecasted federal and state income tax expense is based on SFAS 109. Mr. Salser will discuss in his direct testimony the Company's use of FAS 109 in arriving at the Income Tax calculations,

<u>Rate Base - Deferred Investment Tax Credit</u>

The next rate base element is deferred investment tax credit. The Company is currently amortizing its 3% deferred investment tax credit (pre-1971). The actual balance of the 3% deferred investment tax credit as of the end of January, 2004 was $131,711. The forecasted monthly amortization is applied, producing a forecasted test-year, 13-month average balance of $117,518 which is being deducted from rate base.

<u>Rate Base-Deferred Maintenance</u>

The next rate base element is deferred maintenance. The Company has developed a 13-month average of deferred maintenance projects based upon both actual projects deferred and projects forecasted to be deferred.

These projects include the repainting and repairs of system water storage tanks, and other major repairs of pumps and traveling screens as shown in the workpapers that support Schedule B. There are three tank paintings scheduled for completion in 2004 at a cost of $129,296, and three tank paintings scheduled for 2005 at a cost of $670,000 that have not previously been approved for amortization by the Commission. Based upon these actual expenditures and the forecasted expenditures for 2004 and 2005, as adjusted for amortizations, the Company has developed a 13-month average of these deferred maintenance items totaling $2.454 million.

<u>Rate Base - Deferred Debits</u>

The Company is requesting a rate base addition of $6.738 million for various deferred debit items. These amounts are offset by their applicable deferred taxes discussed earlier. The Company developed its 13-month average addition to rate base for items both deferred and recognized in prior cases by the Commission and new items requested in the current case. The other deferred debits for which rate base treatment is being requested in this case are shown on the workpapers supporting Schedule B.

The Company is proposing rate base treatment for four new deferred items as previously covered in this testimony. Those four new items are i) customer care center transition costs, ii) shared service center transition costs, iii)

security costs, and iv) the acquisition adjustments for the Tri-Village and Elk Lake acquisitions.

70. Q. MR. MILLER, PLEASE CONTINUE WITH THE NEXT RATE BASE ELEMENT SHOWN ON SCHEDULE B-1, PAGE 2 OF 2.

A. The next Rate Base element is titled Other Rate Base elements which is comprised of four items as discussed below:

<u>Rate Base – Other Rate Base Elements</u>

In the last rate case, the Commission reduced rate base for Contract Retentions, Unclaimed Extension Deposit Refunds and Accrued Pension. The Company has calculated a rate base reduction of $2.154 million for these items based on the Commission's Order in Case No. 97-034.

<u>INCENTIVE PLAN COSTS</u>

71. Q. WHAT DID THE COMMISSION INDICATE IN ITS ORDER IN CASE 2000-12- ABOUT THE INCENTIVE PLAN AND COSTS?

A. The Commission said, "However, based on evidence of this proceeding, the Commission is reconsidering its position on this issue and is herby placing Kentucky American on notice that, in future rate proceedings, it must demonstrate fully why shareholders should not bear a portion of these costs."

72. Q. HAS THE COMPANY REVIEWED ITS INCENTIVE PLAN AND WHAT

POSITION IS IT TAKING IN THIS CASE?

A. The Company has reviewed both its long-term and annual incentive plan and believes that the Incentive Plan is in line with those in place at many other utilities, is a necessary part of the overall compensation package if the Company is to attract and retain highly qualified management employees, and provides incentives that promote efficiencies, high quality and reliable service, lower operating costs, and customer satisfaction. In the ratemaking process the Company's stockholders can not retain the financial benefits derived from the incentive program once it files a rate case and those lower costs are embedded in rates. It would not be fair or in line with the regulatory compact to flow through those benefits to the customers and not ask those customers to pay for the incentive plan costs that are in place to promote those savings. The Company believes the incentive plan costs promote the cost savings and efficiencies that benefit the customers in the form of lower rates and should be approved for rate recovery in this case.

73. Q. PLEASE DESCRIBE THE CURRENT ANNUAL INCENTIVE PLAN OF THE COMPANY?

A. The Company has just enacted a revised incentive plan for 2004. The 2004 American Water Annual Incentive Plan (AIP) recognizes the opportunity and the accountability each participant shares in achieving the goals. As with the previous AIP, all full time management, professional and technical employees (exempt from overtime) in American Water are eligible to

participate in the AIP. The award opportunity from the AIP will be based on each employee's role and will be confirmed in writing.

74. Q. WHAT ARE THE AIP MEASURES?

A. The AIP is designed to reward participants for the performance results they and the Company attain during the plan year. There are three performance components:

- **The <u>Financial</u> component includes two measures – Value Added and Free Cash Flow. Value added is the product of the pre-tax operating result return on total invested capital in relation to the cost of capital, and Free Cash Flow would equal Cash from Operations less Capital Investment and is linked to the level of net debt of the company. Goals will be set for the business unit in which each employee works based on the 2004 budget.**
- **The <u>Operational</u> component includes performance measures tied to the American Water balanced scorecard through which customer service, environmental and health & safety, as appropriate to each employee, are the key performance indicators.**
- **The <u>Individual</u> component includes objectives (Key Performance Indicators) within the Company's performance management process. Each employee will develop five Key Performance Indicators to be agreed by the participant and their manager.**

75. Q. HOW WILL THE AWARD BE WEIGHTED?

A. Any AIP award will be weighted for KAW employees at 60% Financial, 25% Operational, and 15% Individual KPI's. The final award will be determined based on the achievement of the goals in each section independently based on performance in each segment. Based on prior history and analysis of the forecast, the Company has included $205,719 of expense for the AIP in the forecasted test-year.

76. Q. HOW WILL EACH PARTICIPANT'S AIP BE DETERMINED?

A. It will be essential that participants be accountable for, measured on and rewarded for performance that they can directly impact and influence. That is why performance measures for the financial component will be based on the local organization (i.e. Kentucky American Water). Similarly, the operational and individual measures and goals that apply will reflect each participant's role. The individual performance will be assessed using American Water's Performance Management and Development Review (PDR) process. The PDR forms contain a scorecard in which each individual KPI will be documented. KPIs are individual performance objectives that will be discussed, weighed to importance, and agreed to by the supervisor.

77. Q. WHY SHOULD THE AIP COSTS BE RECOVERED IN RATES?

A. In the Company's Management Audit conducted at the request of the Commission in the early 1990's it was clearly identified that incentive compensation was a utility trend and recommended it be explored. The

management audit provided some general industry data at that time, indicating 23% of compensation packages included short-term incentive plans and 26% of compensations packages included long-term incentive plans. While we have not reviewed the compensation of all utilities we believe the use of some form of Incentive Compensation is even more prevalent in the utility industry today.

The Commission reached the following conclusion in Case No. 97-034, "Kentucky American has shown that it implemented the incentive package in response to a recommendation made in a Commission-mandated management audit. Furthermore, the Commission determined in Case No. 95-554 that Kentucky American had met its burden of proof by showing the cost of its incentive bonus plan as appropriate for rate-making purposes."
It is the norm in utilities and the general corporate environment today that a portion of the compensation package is tied to specific performance and impact on meeting financial, operational, customer satisfaction, and individual goals. In other words, if an individual does not perform up to expectations their compensation suffers, and they have an incentive to improve performance.

In summary, the Company believes it is appropriate to include incentive compensation for recovery in rates because it is part of the overall compensation package (the norm in the utility industry) and is required to

attract and retain the talent and expertise required to operate a water utility. It also promotes employee performance that leads to increased financial and operational performance, and customer satisfaction.

78. Q. PLEASE ADDRESS THE LONG-TERM INCENTIVE PLAN?

A. The Company for a number of years has had a Long-term Incentive Plan (LIP) and this has been addressed in previous rate cases. The program was developed from a market study that analyzed market data on the use of such plans in companies and the water industry. The study recommended that such plan be adopted by American Water in order to attract and retain highly qualified and capable individuals for its key executive and director positions. The LIP is administered by the Compensation and Management Committee of the Board of Directors of American Water Works Inc. Executives and other key employees of the Company who are designated from time to time by the Committee, based on the recommendation by the President of the Company, are eligible for the LIP. Mr. Mundy, President of the Company is the only KAW employee eligible for the LIP.

79. Q. WHAT IS THE PURPOSE OF THE LIP?

A. The Company believes it is essential that it attract and retain highly qualified executives to maintain the quality of service expected in the Company by its customers and employees. The water industry requires executives that are highly educated and possess a great deal of experience in technical and financial areas. The Company believes in order to attract and retain

executives in its operations, such as Mr. Mundy, it must include a competitive compensation package that will develop the continuity required to provide the excellent customer and operational service and strong financial performance that benefit the customers in the form of satisfaction and lower rates. The awards place a portion of the executive compensation at risk based on the strong financial and operation performance that is expected of these key individuals. Based on past history and review of the financial and operational forecast the Company has included $23,427 for the LIP in its forecasted test-year expense levels.

80. Q. HOW DO THE CUSTOMERS BENEFIT FROM STRONG FINANCIAL PERFORMANCE?

A. I stated this earlier, but will do so again. The Stockholders do not permanently retain the financial benefit from synergies generated from any source, in this case those generated from the performance based incentive plan. In the short-term those savings offset rising costs in other areas, such as inflationary trends or additional capital costs, and may delay the need to seek increased rates. When other factors and cost increases drive the need to increase rates, those benefits flow directly to the customers in the form of rates lower than they otherwise would have been. It would not be fair or in line with the regulatory compact to expect the stockholders to absorb the cost of a plan designed to promote financial performance, operational efficiencies, and quality service all for the benefit of the customers we serve.

81. Q. PLEASE PROVIDE A SUMMARY OF YOUR TESTIMONY ON THE ANNUAL INCENTIVE PLAN?

A. The Company believes the position and justifications determined by the Commission in the Company's rate cases numbered 95-554, 97-034, and 2000-120 approving the cost of the Incentive Compensation Plan are still present and valid in this case and should be approved.

<u>PERFORMANCE BASED RATEMAKING</u>

82. Q. IN THE COMPANY'S PREVIOUS RATE CASE NO. 2000-120, WHAT DID THE COMMISSION SAY ABOUT PERFORMANCE BASED RATEMAKING?

A. The Commission at page 71 of the Order says, "The Commission believes that, at a minimum, Kentucky American should consider whether such regulatory approaches may be beneficial to the Company and other stakeholders. We place Kentucky American on notice that, in its next general rate case proceeding, it will be questioned on its efforts in this area and it will be required to explain why performance based rate-making ("PBR") is not appropriate in its case."

83. Q. HAS THE COMPANY LOOKED AT THE APPLICABILITY OF A PBR APPROACH IN DETERMINING THE MANNER TO FILE ITS REQUEST TO INCREASE RATES IN THIS CASE?

A. Yes. The Company has explored the use of PBR in the utility ratemaking

area by reading available information on the subject from trade publications, information from regulatory commission orders and various other data on the subject.

84. Q. WHAT IS THE COMPANY'S GENERAL PERCEPTION ABOUT THE USE OF THE PBR APPROACH FOR SETTING RATES FOR THE COMPANY?

A. PBR has been used primarily in the electric and gas industries. PBR programs appear to have been used in these industries in part due to the impacts of deregulation and as a mechanism that encourages efficiency by the utilities and less frequent general rate cases. After reviewing the particular circumstances faced by the water industry and specifically the Company, we do not believe a PBR approach would meet the regulatory compact of balancing the needs of the customers, the Company, and its stakeholders.

85. Q. DO YOU KNOW OF ANY WATER UTILITY IN THE UNITED STATES THAT IS CURRENTLY OPERATING UNDER A PBR APPROACH?

A. In reviewing the data available to us we are not aware of any water utility that is regulated under a PBR approach. While there are many forms of PBR we could not locate any water utility that has PBR mechanisms similar to those that are in effect for utilities in the gas and electric industry.

86. Q. WHAT WOULD BE THE TYPES OF COMPONENTS USUALLY IN

PLACE WITH PBR?

A. There are many forms of PBR's but the ones I am most familiar with include some combination of the following provisions. I am sure there are many other variations of the types of PBR components covered here.

1. A price cap for some specified period of time whereby the utility is able to retain the positive result of its actions on earnings but accepts the risk of events that may negatively impact its earnings.

2. In some instances a range for achieved ROE is established, and this approach may include a sharing of the positive or negative earnings outside the prescribed range of ROE.

3. The PBR may include the utility providing a forecast of its expenses, capital spending, and capital needs over a specified period; and rates are set to cover the cost of service over that period agreed to with the regulators. In effect this type of PBR sets in place a predetermined level of service, expense levels, and capital spending programs over the period of the PBR at the time it is approved. The Company absorbs the financial risk for events that impact their cost of service. Usually these types of arrangements include a commitment by the utility to maintain service at certain levels as measured by various performance indicators.

4. Other PBR's may include a price cap, but include provisions for changes in rates for certain types of expenses (such as a change in tax rates), or if earnings fall below a certain level.

87. Q. WHAT FACTORS PRESENT IN THE WATER INDUSTRY DO YOU BELIEVE HAVE CONTRIBUTED TO THE LACK OF PBR APPROACHES IN THIS INDUSTRY?

A. The water industry in general has faced and continues to face the need to address significant capital and infrastructure improvements. Ever increasing water quality regulations and plants nearing their useful life require treatment plant upgrades or replacements. Many water utilities have a significant investment need to replace miles of small diameter mains that have been in service for many years. In many cases these mains have exceeded or are nearing their useful life. In many cases the capital improvement needs for water utilities exceed internal cash. It would be difficult to attract the capital necessary to meet its service commitments and provide the capital improvements in the situation just described, and at the same time maintain a fair and reasonable return on that investment if under a price cap. The major driver of increased rates in the water industry has been capital improvements. The current level of capital improvement requirements in the water industry would make it very difficult for water utilities to operate effectively under a PBR approach, if such a PBR approach included a price cap.

88. Q. WHAT OTHER FACTORS IN THE WATER INDUSTRY WOULD TEND TO MAKE PBR APPLICATIONS UNATTRACTIVE?

A. Because water utilities are more capital intensive than other utilities a large

portion of their cost of service is fixed and does not vary with levels of sales. The capital cost to service its investments, depreciation, and property based taxes make up a large portion of the cost of service of most water companies. In addition, a large portion of the operating expenses of a water utility do not vary with consumption. A certain level of employees is required to maintain service, and the majority of other operation expenses are not tied to sales levels. The costs that are tied directly to sales levels, production costs for fuel & power, chemicals, and waste disposal make up only a minor portion of the cost of providing water service. The lack of flexibility to adjust its operation and capital costs when sales decline or a large unexpected expense is required to meet changing regulation would tend to make it difficult for a water utility to function adequately under a PBR that included a price cap. Given the lack of flexibility to adjust costs, the Company would have to accept earnings that may be inadequate to attract capital or the other option being to cut service levels to save on expenses or put off capital improvements that would be required to meet service needs. The Company does not believe that would be in the best long-term interest of the customers.

89. Q. WHAT CIRCUMSTANCES SPECIFIC TO THE COMPANY WOULD INDICATE THAT A PBR APPROACH MAY NOT BE IN THE BEST INTEREST OF THE COMPANY AND ITS CUSTOMERS?

A. The Company's capital investment from 1999 to 2003 has exceeded internally generated funds by $18.433 million. The Company continues to face

significant capital improvements over the foreseeable future. In fact, the extent and timing of the capital investment of the next five years is subject to increase significantly if a solution to the source of supply issue is finalized. As the Commission is well aware the Company has demonstrated that it has a deficiency in its source of supply in times of drought. The Company is currently working with the Bluegrass Water Consortium and the Kentucky River Authority to develop a solution to that supply shortage. It is uncertain at this time what the ultimate solution or the final cost will be. The Company's variable production costs make up less than 9% of its cost of service or approximately 24 cents per 1000 gallons sold. Because of the supply shortage it is unlikely that the Company has any significant upside to its earnings even in dry years when water sales can increase significantly. Because of the supply shortage, the Company would most likely have to institute water restrictions in times of severe drought or periods of prolonged hot and dry weather conditions. The Company has very little potential for an upside to its earnings potential, but because of the lack of flexibility in its costs has a significant down side potential. As evidence of this please refer to Exhibit MAM-1. Since the 2000 rate case, the Company has achieved an ROE significantly under the level authorized in the 2000 rate case.

90. Q. WHAT IS THE POSITION OF THE COMPANY IN THIS CASE REGARDING THE USE OF A PBR ARRANGEMENT FOR KENTUCKY AMERICAN WATER?

A. Given the uncertainty of a solution to the source of supply deficit and its impact on future capital improvement requirements, the lack of significant flexibility in its expense levels, and the high proportion of investment related capital costs in its cost of service a PBR arrangement would not appear to be an attractive option for the Company, or in the best interests of its customers at this time. This would be particularly true if the PBR arrangement included a price cap or a prolonged rate stay-out provision that would limit the Company's ability to address the source of supply issue, or other water quality and service issues appropriately.

<u>CHANGE IN MONTHLY ACCOUNTING CLOSING SCHEDULES</u>

91. Q. PLEASE TELL US ABOUT A CHANGE IN THE MONTHLY CLOSING SCHEDULE CURRENTLY USED BY THE COMPANY?

A. The Company beginning in 2003, began to use a different closing schedule from the calendar month close historically used. The closing date for each accounting period is determined based on the 4-4-5 method. Each quarter the first accounting close is the fourth Friday, the second close is the fourth Friday, and the quarter close is on the Fifth Friday. This change allows the Company to close the books more quickly and timely and permits review of financial statements more timely. This change has no impact on the annual P&L Statement, and only minor impact on the allocation of revenue and expenses on each quarterly closing.

92. Q. HOW HAS THE COMPANY HANDLED ANY ADJUSTMENTS NECESSARY TO ITS BASE OR FORECASTED PERIOD TO REFLECT THE INFORMATION IN ITS FILING ON A 12 CALENDAR MONTH BASIS?

A. The Company has made the adjustments necessary to reflect a full 365 days of revenue in both its base and forecasted test-years. The base period 6 month actual data ended with a closing date of January 30 and the forecasted portion of the base period ended with a closing date of July 30. Since both of these dates are a Friday and the month ended the next day on a Saturday, there would be little if any impact on expense levels.

<u>ALLOCATION OF COSTS</u>

93. Q. MR. BUSH ADDRESSES THE ALLOCATION OF CERTAIN COSTS. WOULD YOU ADDRESS THE SPECIFIC RATEMAKING TREATMENT OF THOSE COSTS BEING REQUESTED IN THIS CASE?

A. Yes. The Company since its last case has acquired the assets of the Tri-Village and Elk Lake systems in Owen County and is performing contract operations for systems in Pineville, KY and the Bluegrass Station Division. It is appropriate that the Company allocate a portion of its corporate expenses to these entities for the purpose of setting rates in this case. Mr. Bush has identified the appropriate expenses requiring allocation in this case and has established what we believe to be appropriate allocation factors. The Company is requesting the full allocation of costs to the contract operations

at Pineville and Bluegrass Station be recognized below the line for ratemaking purposes. The Company's filing includes separate tariffs for the Central Division and the Northern Division operations at Tri-Village and Elk Lake. The Company is requesting that only one third of the allocation applicable to the Northern Division be recognized in the tariffs approved for those districts with the remaining two-thirds remaining in the Central Division tariff.

94. Q. WHY WOULD THE COMPANY NOT WISH TO ALLOCATE THE ENTIRE PORTION OF THE COSTS IDENTIFIED IN THE SCHEDULE PREPARED BY MR. BUSH TO THE NORTHERN DIVISION DISTRICTS?

A. The tariffs of Tri-Village and Elk Lake are substantially higher than those in the Central Division. If the entire identified allocation of costs were applied to the tariffs approved for the Northern Division districts it would have a major impact on the rates charged in those two districts. To avoid the <u>rate shock</u> presented by this situation, the Company is requesting that only one-third of those costs identified for allocation be applied in this case. The remaining two-thirds, or $86,341, would remain in the cost of service for the Central Division and would make up only a minor portion of the costs recovered from those customers.

95. Q. HOW WOULD THE COMPANY HANDLE THIS ISSUE IN FUTURE

RATE CASES?

A. The Company believes the service it provides across both its Northern and Central Divisions are uniform. Given that the customers will receive uniform service across its service territory, the Company plans to propose in its next rate case a move to a uniform tariff for all customers. The Company believes this will promote fairness to all its customers, promote the Company's ability to address water service issues in other areas of Kentucky that need the expertise and economies of scale available through the Company, and promote economic development in the State. The Company believes this can be accomplished with only minor impact to the nearly 110,000 customers of the Central Division.

<u>OTHER TARIFF ISSUES</u>

96. Q. OTHER THAN A CHANGE TO METERED TARIFFS WHAT NEW TARIFFS OR ADJUSTMENT TO TARIFFS IS THE COMPANY PROPOSING?

A. The Company is proposing revisions to its tap fee tariff. The Company is also proposing new tariffs to address an activation fee, an emergency pricing tariff to be implemented only during the water rationing phase of its demand management plan and a low income tariff. I will also discuss an economic development tariff that the Company plans to request once a solution to the source of supply issue is finalized.

97. Q. WHO WILL ADDRESS EACH OF THOSE TARIFF ISSUES?

A. Ms. Bridwell will address the tap fee. Mr. Bush will address the activation fee and the emergency pricing tariff. I will address the overall position of the Company on these tariffs and specific issues regarding the low income and the economic development tariffs.

98. Q. WHAT IS THE COMPANY'S GENERAL POSITION ON TARIFFS OTHER THAN METERED TARIFFS?

A. The Company believes costs generated by, and easily identifiable for, specific customers should be recovered from those customers generating the activity and cost. The Company in its last case established a tap fee that recovers the cost of new taps and meters directly from the new customers. The Company has historically had a reconnect fee to cover the cost of re-establishing service for the customers who are terminated for non-payment. There are also fees to recover the cost of bad checks, inspection of service lines, and after hours turn-ons. We believe these fees make sense and hold down the cost of the metered tariff to those customers who do not generate these costs.

99. Q. WOULD YOU COMMENT ON THE ACTIVATION FEE?

A. The calculation of the cost of a service order required for activation of service is covered by Mr. Bush. The activation fee is a new fee being proposed to cover the cost of activating service where the previous customer may have moved or sold the house or apartment, and a new customer is initiating service at the location. This is a specific customer cost that can be

easily identified and recovered from the customer generating the cost. If approved this tariff is estimated to generate $672,000 per year and would eliminate the need to recover this cost from the metered tariff and the vast majority of customers who do not generate this cost. Activation fees are common in the telecommunication industry, and there are many instances where such fees have been approved for water and sewer utilities. The Company believes the activation fee for a new customer is clearly identifiable to that customer, is consistent with the tap fee and reconnection fee for non-payment already recognized in the approved tariff, and should be approved by the Commission in this case.

100. Q. PLEASE ADDRESS THE LOW INCOME TARIFF BEING PROPOSED IN THIS CASE?

A. The Company is requesting for the first time as part of this case a discount of 25% on the service charge for households who qualify. The discount would, if approved, be applied to those customers at or below the federal poverty levels who register with an independent third party agency. This discount would generate a $2.12 reduction in the monthly residential water bill for those customers who qualify and register for the program at an annual cost estimated at $30,000.

101. Q. WHO WOULD PAY FOR THE LOWER REVENUE GENERATED BY THE DISCOUNT TO THOSE WITH LOW INCOMES THAT REGISTER?

A. The Company proposes the cost of the discount be spread across all customer classes. If approved in the manner proposed by the Company, this tariff would cost the customers who do not qualify only an additional $2.4 cents per customer per month.

102. Q. DO THE COMPANY'S STOCKHOLDERS ALSO CONTRIBUTE TO ASSISTING THOSE CUSTOMERS WHO HAVE TROUBLE PAYING THEIR MONTHLY WATER BILL?

A. Yes. The stockholders of Kentucky American Water contribute $5,000 each year to the "Water For Life Fund", which is combined with a voluntary $1 dollar contribution from customers to assist customers having difficulty paying their water bill. The fund had available $6,263 for assistance to needy customers in 2003.

103. Q. WHY SHOULD THE LOW INCOME TARIFF BE APPROVED?

A. These types of low income tariffs are present in many states to assist those customers who have financial difficulty paying utility bills. They have historically been more prevalent in the energy utility area, but are also now being implemented for water companies. Pennsylvania American Water has had a similar tariff in place for a number of years and a similar tariff is being proposed in West Virginia. The Company believes the low income tariff when combined with the "Water For Life Fund" described above will assist those customers who have the most difficulty in meeting monthly payments

and should be approved in this case.

104. Q. WOULD YOU PLEASE ADDRESS THE "NEW AND EXPANDED ECONOMIC DEVELOPMENT TARIFF" THE COMPANY WISHES TO PROPOSE IN THE NEAR FUTURE?

A. Yes. The Company believes that utility infrastructure, and particularly water infrastructure, is one of many key elements of a company's decision to locate in a particular area. The Company also believes that economic development and jobs creation are critical to the continued economic stability of the State and service area covered by Kentucky American Water. The Company and its customers benefit when new commercial and industrial customers locate to its service territory. The jobs created provide growth and revenue to the general economy, and the additional water sales generate revenue and a larger base on which to spread fixed costs. These factors benefit the Company in the short run and its customers over the long-term in the form of lower rates. This win-win situation is something that the Company believes it should encourage through its tariffs.

105. Q. WHAT WOULD BE THE FACTORS THAT PERMIT A COMPANY LOCATING IN THE SERVICE AREA TO UTILIZE THIS TARIFF?

A. Ms. Bridwell addresses the source of supply issue for the Company and the Company is certainly concerned about a supply deficit when drought years impact the supply. However, the Company believes the source of supply

issue will be resolved, and the Company should have a mechanism in place to encourage economic development in its service territory that promotes the development and job growth providing benefits to the overall economy of the area, the financial well being of the Company, and ultimately lower rates to our customers. As indicated in the draft "New and Expanded Economic Development Tariff" attached as Exhibit MAM-10, a new Commercial or Industrial customer would have to meet the following requirements for the tariff to apply: 1) be a new customer or an existing customer requesting a separately metered facility, whose new facilities create 50 new permanent jobs for a new customer application, or in the case of an existing customer create 50 new permanent jobs or an increase of 10% over existing employee levels which ever is higher, 2) uses a minimum of 50,000 gallons per day or 1.5 million gallons per month, at a load factor not to exceed 1.4 times the average daily load, 3) request service under the tariff prior to the customer having committed to moving into or expanding within the Company's service territory, 4) applicable only to customers where economic incentives have been offered by a governmental entity in conjunction with the new or expanded facilities and accepted by the customer, and 4) provide sufficiently detailed information to enable the Company to determine whether the new customer or additional facilities meet the required criteria.

106. Q. WHAT WOULD BE THE DISCOUNT LEVEL AND TERM OF THE DISCOUNT?

A. The Company envisions the term of the discount would be for five years. The discount in year 1 would be 30%, year 2-25%, year 3 – 20%, year 4 – 15%, and year 5 – 10%. No discount would be applied after completion of the fifth year of the contract.

107. Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes.